

## Chapter 2

### GOALS OF FUNDAMENTAL TAX REFORM

In undertaking fundamental reform and simplification of the tax system of the United States, it is important to specify clearly and explicitly the goals or criteria that should guide such an undertaking. The criteria underlying the Treasury Department's study of fundamental tax reform are described here. Though some are framed in the familiar context of an income tax, in general they are equally applicable in the context of the less familiar tax on consumed income.

#### Economic Neutrality

One of the primary advantages of a free market economy is its tendency to allocate economic resources to their most productive uses. For example, market forces lead business firms to produce what consumers want in ways that are relatively efficient and economical. Any tax inevitably discourages the type of activity that is taxed. An ideal tax system would, however, interfere with private decisions as little as possible. That is, it would not unnecessarily distort choices about how income is earned and how it is spent. It would not unduly favor leisure over work, or consumption over saving and investment. It would not needlessly cause business firms to modify their production techniques or their decisions on how to finance their activities. A neutral tax policy would not induce businesses to acquire other firms or to be acquired by them merely for tax considerations. It would not discourage risk-taking or the formation of new businesses. It would not discourage competition by granting special preferences only to one industry or one type of financial institution. In short, an ideal tax system would be as neutral as possible toward private decisions. Any deviation from this principle represents implicit endorsement of governmental intervention in the economy -- an insidious form of industrial policy based on the belief that those responsible for tax policy can judge better than the marketplace what consumers want, how goods and services should be produced, and how business should be organized and financed.

Economic neutrality is furthered by a few simple rules of tax design. Perhaps most importantly, income from all sources should be taxed equally; otherwise, too many resources will be devoted to activities subject to the lowest taxes. For the same reason, tax liability should not depend on how income is spent. Uniform treatment of all sources and uses of income requires a comprehensive definition of income for tax purposes.

#### Lower Tax Rates

The higher tax rates are, the more taxes interfere with economic choices -- choices about working, about saving and investing, about production techniques and business finance, and about invention and

innovation. Moreover, any omission from the tax base is more valuable at high tax rates than at low rates. As a consequence, there is more political pressure for preferential treatment of selected activities at high rates, and tax shelters are more important at high rates. Thus an important goal of tax policy is to keep tax rates as low as possible, given other objectives. Of course, the tax rates needed to raise a given amount of revenue can be lower, the more income is subject to tax. This is a second important reason for adopting a comprehensive definition of taxable income. It is far better -- more neutral, as well as simpler and more equitable -- to levy low tax rates on all income than to impose high tax rates on only part of income.

### **Revenue Neutrality**

The Treasury Department study of fundamental tax reform has concentrated on questions of tax structure and has not considered any proposals to increase the level of tax revenues that will result from current law. Thus the Treasury Department proposes tax reforms that are revenue neutral, that is, reforms that would leave revenues essentially unchanged from what they would be under current law.

### **Equal Treatment of Equals**

A tax that places significantly different burdens on taxpayers in similar economic circumstances is not fair. For example, if two similar families have the same income, they should ordinarily pay roughly the same amount of income tax, regardless of the sources or uses of that income. A fair tax system does not allow some taxpayers to avoid taxes by legal means or to evade them by illegal means.

The only way to achieve equal treatment of equals is to define the tax base comprehensively. If some items of income are omitted from the tax base, or if particular expenditures are treated preferentially, then taxpayers who are otherwise in equal positions will not be treated equally.

### **Fairness for Families**

It is commonly agreed that households with incomes below the poverty level should pay little or no tax. Otherwise, they will be paying taxes with income that is needed to maintain a minimal standard of living. In a real sense, families with poverty-level incomes do not have taxpaying ability. Taxpaying capacity exists only once income exceeds the poverty level.

### **Fairness Across Income Classes**

Most Americans probably agree that those with high incomes should pay a greater percentage of their income in tax than those with intermediate levels of income. But the proper pattern of effective tax rates -- the percentage of income paid in taxes at various income levels -- is a matter on which opinions differ.

In its study of fundamental tax reform the Treasury Department has adopted the simple working assumption that the existing distribution of tax payments across income classes should not be significantly changed by tax reform. If any change in the existing distribution of tax burdens is desired, it can and should be implemented by adjusting the proposed personal exemptions and rate schedules. It should not be achieved by taxing some sources or uses of income more or less heavily than others, since that would violate both economic neutrality and the principle that those with equal incomes should pay approximately equal taxes.

Defining the tax base comprehensively is necessary for the achievement of equity across income classes. Any exclusion or deduction is worth more, the higher the marginal tax bracket of the taxpayer. Moreover, wealthy taxpayers make relatively greater use of many provisions of the tax law that reduce the tax base, especially those yielding business deductions that result in the mismeasurement of economic income and produce tax shelters. As long as these tax preferences exist, the tax system will be less progressive than the rate structure suggests, and high marginal rates will be advocated as a means of achieving progressive taxation. Conversely, if income is defined comprehensively, the existing pattern of progressivity can be maintained with markedly lower marginal tax rates on upper income groups, as well as other taxpayers.

Tax reform that does not alter the distribution of tax burdens across income groups will, of course, involve redistribution of tax burdens -- winners and losers -- within income classes. This is only natural in the context of reform that attempts to replace the inequities of the present tax system with equal treatment of households with a given income. Those who gain from any such reform will be those who, at a given level of income, have been paying more than average amounts of tax, and those who lose will have been paying less than their fair share of taxes. But many of the losers will not lose permanently; they will simply divert funds from uneconomic investments to more productive investments and pay lower tax rates on the higher income that results.

### Simplicity

An important goal of the Treasury Department study of fundamental tax reform is simplification. During June of 1984, the Treasury Department held hearings on fundamental tax reform in seven U.S. cities. One of the themes repeated most frequently by citizens appearing at those hearings was the need for simplification of the income tax.

Though simplicity in taxation may be difficult to define, everyone knows what it is not. Simplicity is not reflected in a tax system that requires extensive recordkeeping by ordinary citizens. A simpler system would require fewer taxpayers to collect and retain receipts or cancelled checks in order to calculate and document tax deductions,

adjustments, and credits. Simplicity is not wondering which receipts and checks to save because the tax law is too complex and is constantly changing. Simplicity is not computing dozens of deductions and credits, and wondering all the while whether other means of saving tax might have been missed through ignorance of the laws. Nor is simplicity being forced to wade through long and complicated instruction booklets or resort to professional assistance, in order to meet the civic responsibility to pay taxes. A simple tax system would not require 41 percent of all taxpayers -- and about 60 percent of those who itemize deductions -- to engage professional assistance in preparing their tax returns. Under a simple system, most responsible taxpayers would be more certain of their tax liabilities.

Reduced costs and greater ease of administration for the government are the mirror image of simplicity for the taxpayer. Many provisions of the tax code could be administered effectively only by devoting exorbitant resources to their enforcement. About 90 percent of taxpayers who itemize deductions make at least one error in claiming their deductions, but the Internal Revenue Service simply does not have the capacity to audit all returns and either collect the tax due or make refunds to these taxpayers. The current tax structure creates a dilemma for tax administrators. Effective enforcement of complicated laws generally creates complexity for the taxpayer and fosters apprehension and resentment against the fiscal authorities. On the other hand, ineffective enforcement loses revenue, it creates uncertainty for taxpayers, it converts the tax system into an unfair tax on honesty, and it may also generate hostility toward the tax system. A primary focus of the tax reform study has been to eliminate and avoid provisions that would unduly complicate tax administration and compliance for most taxpayers.

### Perceived Fairness

The perception of fairness may be as important as fairness itself as a goal of tax policy. The United States was once justly proud of the taxpayer morale of its citizens. With media coverage of tax shelters now commonplace and talk of "beating the system" prevalent in conversation, taxpayers increasingly view the tax system as unfair and wonder why they should pay taxes. One of the primary goals of the Treasury Department study of fundamental tax reform is the reversal of this threatening trend.

The growing use of the income tax to subsidize various forms of economic activity is a major source of the increase in the perceived lack of fairness of the tax system. The U.S. Government has long spent public funds in ways that many taxpayers question. While this may cause many to believe that their tax dollars are being wasted, it does not raise doubts about the equity of the tax system itself. The situation is very different when the tax system, rather than direct spending, is used to provide subsidies. Similarly situated taxpayers can pay considerably different amounts of tax, depending on how they earn and spend their income, and high-income families may pay tax on a smaller portion of their income than do poorer families. The result

is a perception that the income tax itself is unfair, both within and across income classes.

Reforms of many types are needed to improve the image of the U.S. income tax. Families below the poverty line should pay little or no tax. Income tax compliance should be easier and less expensive. Most forms of economic income should be subject to tax, but fictitious income representing nothing but inflation should not be taxed. The tax system generally should not be used to implement subsidy programs. Opportunities for tax shelters should be sharply curtailed, if not eliminated. Tax evasion should be made more difficult. Adoption of fairer tax rules would have a multiplier effect, as increased fairness would lead to an improved perception of fairness and, in turn, to better compliance.

### An Inflation-proof Tax Law

Starting in 1985 personal exemptions, the zero bracket amount, and the tax brackets in the individual income tax will be adjusted for inflation. This important innovation, commonly called indexing, will prevent taxpayers with a given real income from being forced by inflation to pay higher taxes. It should remain an inviolate part of the tax system. Indexing of this kind, important as it is, meets only part of the need to protect taxpayers from inflation. Inflation adjustment in the calculation of taxable income is perhaps more important, because it cannot be achieved by periodic adjustments of personal exemptions and the rate structure. Without it inflation causes mismeasurement of business and capital income.

Inflation currently causes income to be overstated in at least four ways. First, depreciation allowances based on historical costs are generally not adequate to allow tax-free recovery of investment in a time of inflation. Second, deductions for the cost of goods sold from inventories are inadequate if based on historical costs. Third, capital gains include nominal appreciation that merely reflects the general rise in prices, rather than an increase in the real value of assets. Fourth, nominal interest receipts include an inflation premium that should not be taxed. By the same token, full deduction for nominal interest expenses during inflationary times results in the understatement of real economic income.

Congress has made some ad hoc adjustments in depreciation allowances and the taxation of capital gains in response to inflation. In most cases these measures do not accurately adjust for inflation, and they are too inflexible to deal adequately with changes in the rate of inflation.

An ideal income tax system would provide inflation adjustments in the measurement of taxable income in order to prevent the taxation of fictitious income and the deduction of fictitious interest expenses. Such adjustments would prevent the effective tax rates imposed on business and capital income from varying dramatically and arbitrarily every time the inflation rate changes.

### Neutrality Toward Business Form

Corporate income that is distributed as dividends is subject to tax twice, first at the corporate level and again when received by individuals. Many observers -- among them economists and lawyers, businessmen, and public officials -- have argued that a separate unintegrated tax on corporate profits has adverse economic effects and makes no sense. Yet the corporate and individual income taxes cannot be fully integrated, for technical reasons, and the corporate tax cannot simply be eliminated without creating a large loophole. It is, however, possible to relieve double taxation of dividends, keeping full taxation at the corporate level only for income that is retained.

The Treasury Department study of tax simplification and reform has been guided by the need for balance in the treatment of corporations and individual taxpayers. The corporate tax rate should be no higher than -- and, as has been the case historically, perhaps somewhat below -- the top rate applied to income of individuals. If the corporate rate and the top individual rate differ significantly, there would be an artificial inducement either for or against use of the corporate form.

### Economic Growth

The U.S. economy has long been hampered by a combination of defects in its tax system. High marginal tax rates discourage work, saving and investment, and invention and innovation. Heavy reliance on income taxation, rather than taxes on consumption, has produced a further disincentive for saving. Preferential tax treatment of particular industries -- industrial policy implemented through tax policy -- causes too much labor and capital to flow into the favored industries, and too little into other sectors. In many instances, it is difficult to establish new businesses simply because the tax system places them at a severe competitive disadvantage. In extreme cases tax-preferred investments that lose money on a before-tax basis are profitable once tax savings are considered. The result of all this tax-induced interference with market forces is lost opportunities for productive investment and needless sacrifice of national output. Economic growth, a primary goal of the study of fundamental tax reform, depends on a neutral tax system -- one that would not hinder the potential for growth inherent in a free market economy.

### Trade-offs

In many cases the objectives of tax policy discussed above are quite consistent. Elimination of deductions not required for the accurate measurement of income would generally simplify the tax system, promote horizontal equity, allow lower tax rates, and reduce existing distortions of economic decisions. Sometimes, however, it is necessary to strike a balance among competing objectives of sound tax policy. In some cases -- extraordinary medical expenses or the presence of dependents, for example -- deductions are justified because they affect ability to pay even if they do not affect income.

Many of the deductions and credits that complicate the tax system were enacted -- and are defended -- as necessary to avoid inequities. For example, almost everyone agrees that taxpayers should be allowed to claim exemptions for dependents, but implementing the dependency test can be complicated in certain cases. Deductions for extraordinary medical expenses are necessary for the measurement of the ability to pay taxes; but documenting them can be very time-consuming. Low-income individuals may not realize that they are eligible for the earned income tax credit; they are also least able to deal with the complexity it entails and may not realize that the IRS will compute the credit if a return is filed. The two-earner deduction involves complicated conflicts between equal treatment of equals, incentive effects, fairness to families, and fairness across income classes, as well as trade-offs between these effects and simplicity.

Measuring income accurately or implementing a tax on consumed income, either of which would be desirable on grounds of fairness and neutrality, may involve difficult problems of compliance and administration, for example, in the valuation of certain fringe benefits. Measurement of income as it accrues on infrequently traded or unique assets would present insurmountable administrative problems. On the other hand, taxing capital gains on realizations allows tax to be postponed indefinitely. Calculation of business income is complicated, but legitimate business expenses, including estimated depreciation allowances, must be allowed on both equity and neutrality grounds. Implementing an inflation-proof income tax is complicated, but the alternative is to allow inflation to play havoc with effective tax rates, creating distortions and inequities. And any tax on consumption, whether a sales tax or a progressive personal tax on consumed income, raises troublesome issues of distributional equity.

The Treasury Department has carefully weighed these competing objectives in appraising the strengths and weaknesses of the four options it considered in its study of fundamental tax simplification and reform. Most individuals will face a dramatically simpler tax system under the Treasury Department proposals. But in some cases proposed reforms that are necessary to improve the equity and neutrality of the tax law do conflict with the important goal of simplification.

### Fair and Orderly Transition

The present income tax is complex, it is inequitable, it causes economic distortions, and it impedes economic growth. But movement to a comprehensive tax on all income or consumption, while desirable in the long run, would involve substantial short-run shifts in resource allocation and tax burdens. Even here there are conflicts and trade-offs -- between the advantages of rationalizing tax policy and the disruptions caused by doing so too suddenly or too rapidly.

Tax reform has often -- and long -- been held hostage by failure to deal with transition issues; those who would be hurt by tax reform

have successfully resisted change. An important objective of the Treasury Department's study of fundamental tax reform is the specification of transition rules that will allow tax reform to become a reality. Transition steps are necessary both to ease the impact of tax changes and to make tax reform a political reality. Without them, reform will not occur, and this generation will leave to the next a tax system that remains deeply flawed.

Rather than being introduced suddenly, with little or no time for adjustment, some components of fundamental tax reform should be introduced gradually, in order to avoid windfall gains and losses and economic dislocations. Gradual introduction of fiscal measures can take a number of forms, depending on circumstances. Effective dates can be postponed and implementation can be phased in, starting either at once or at a subsequent effective date. Grandfathering of income from certain assets or of groups benefitting from certain provisions (for example, applying new provisions only to new purchasers of assets, and not to income from old assets) is appropriate in some cases. These mechanisms are among those proposed to meet the final criterion of a fair and orderly transition to a simpler, fairer, and more neutral tax system.

#### **Addendum: Implications for Spending**

Most of the exclusions, adjustments, itemized deductions, and credits currently found in the income tax are not required for the accurate measurement of income or ability to pay taxes. Rather, they are simply subsidies for private activities that are administered through the tax system.

Administering subsidies through the tax system creates complexity for taxpayers. By allowing taxpayers in similar circumstances to pay greatly different amounts of tax, it undermines taxpayer morale in a way that direct spending does not. The Treasury Department thus recommends that most of the exclusions, adjustments, deductions, tax deferral provisions, and credits that are inconsistent with a comprehensive definition of income for tax purposes be repealed or sharply curtailed.

This recommendation should not be construed to imply that none of the currently tax-preferred activities is worthy of direct public support. Such a judgment would go beyond the mandate from the President to propose reforms that will make the tax system broad-based, simple, and fair. Except in a few cases this study makes no recommendations about the need to enact spending proposals to replace subsidies currently administered through the tax system. Of course, to the extent that direct spending replaces tax subsidies, tax rates could not be reduced as much as proposed.